FITCH AFFIRMS A2DOMINION HOUSING GROUP LIMITED AT 'A+'; OUTLOOKS STABLE

Fitch Ratings-Warsaw/London-04 July 2018: Fitch Ratings has affirmed A2Dominion Housing Group Limited's (A2D) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'A+' and Short-Term Foreign-Currency IDR at 'F1'. The Outlooks are Stable. The GBP1 billion EMTN programme long-term rating has also been affirmed at 'A+' as has the GBP250 million senior unsecured long-term rating. A2D Funding plc and A2D Funding II plc's long-term local-currency unsecured bonds have also been affirmed at 'A+'.

Fitch believes A2D is showing strong performance despite the challenges that have affected the sector over recent years. Continued high demand for social and affordable housing, cost-efficiency measures and diversification into non-core business should allow A2D to maintain sufficient revenue to service debts and cross-subsidise its core business.

The Stable Outlooks reflect Fitch's view that developments will not have a material negative impact on the sector despite the weakened operating environment and increased challenges faced by registered providers (RPs) in England. The impact of Brexit on the sector, although still uncertain, appears less evident than on other public finance sectors, such as higher education and healthcare, although the possible consequences have been factored into A2D's stress tests. The Regulator of Social Housing continues to provide strong oversight.

KEY RATING DRIVERS
Fitch rates social housing RPs in England under its Revenue Supported Rating Criteria and takes into account such factors as revenue defensibility, operating risk and the RPs' financial profile assessment. We incorporate public support factors, notably the strong predictability of the RPs' cash flow through direct and indirect government funding. Fitch also applies the Government Related Entity Criteria, whereby we assess RPs in England as non-credit-linked entities and apply a one-notch uplift to the standalone ratings. This reflects the assessment of strength of linkage and incentive to support factors. As a consequence, RPs' ratings do not automatically move in line with those of the UK sovereign.

Revenue Defensibility: Strong
Demand for social housing remains strong and any change in the rents that RPs are able to charge would be unlikely to materially affect demand. Nevertheless, our assessment of revenue is constrained by the lack of control RPs have on rents. The supportive regulatory regime aims to maintain compensation for services at a level consistently supporting solvency for not-for-profit of an essential public service. However, Fitch expects revenue from housing benefits as a percentage of total revenue to eventually fall, due to the increased revenue from non-social housing activity. RPs have the flexibility to collect enough revenue to cover all costs.

Operating Risk: Strong
A2D has well-identified cost drivers and low potential volatility in major items. A2D has material capex in their development plans in the medium term but has opportunities to slow down committed schemes, defer uncommitted schemes as well as switch tenure from sale to market rent.

Regarding resource management risk, there are unlikely to be supply constraints for labour or resources. A2D has factored the Brexit vote and its potential impact on the UK economy, public finances and political continuity into its stress testing. The main implications for the sector will be continued uncertainty and short- to medium-term turbulence in the financial and housing markets, which may lead RPs to further delay any planned bond issuances, and put pressure on refinancing.

Nevertheless, in the financial year ending 31 March 2017 (FYE17) A2D established an EMTN programme and raised GBP250 million as a debut issue at the group's lowest coupon to date of 3.5%.

A2D has already stress-tested and run multi-variable scenarios for its business plan. Critical variants include such scenarios as: loan portfolios being repriced at higher lending margins, sales prices falling, delays in sales, higher inflation, increasing arrears and bad debt, as well as political factors, such as further rent reductions. To mitigate these effects and to be able to comfortably meet covenants, A2D has put forward corrective measures, including pre-emptive and responsive actions. Fitch will continue to monitor the resilience of A2D and assess its ability to overcome possible further turmoil. We will also closely review the robustness of the stress testing relative to its ratings, including the impact of the Brexit vote on its business plan, and assess A2D's flexibility to adapt to market conditions.

Financial Profile: Strong
We expect A2D's strong performance to improve, aided by a mixed tenure development plan that aims to deliver housing for sale as well as affordable housing and market rent properties. Profits from the sale of private sale units will be re-invested in the RP to continue to build and provide affordable social units. Although the share of sales and non-social housing activity is expected to increase in the medium term to 50% from 30% of total turnover, at least half of the turnover will remain from social housing lettings. Debt will continue to increase to fund capital expenditure on development programmes.

A2D is now one of the largest RPs in London and the south-east of England with more than 37,200 units. It reported GBP372 million turnover in FYE17 (latest available published data) and an operating surplus of GBP106 million. Debt at FYE18 rose to GBP1.54 billion and is expected to increase further to GBP1.8 billion by FYE21 (about 3% annually) following investments. However, in its rating scenario Fitch expects that net debt/Fitch-calculated EBIDTA is likely to remain below 12x. A2D's business plan foresees turnover to average about GBP460 million in 2019-2023 with the operating surplus averaging a high of GBP120 million a year.

A2D has no group covenants. However there are interest cover and gearing covenants within its two main subsidiaries, A2D Homes and A2D South. These covenants are met within the BP and in the stress tested BPs, albeit with diminished headroom. A2D has developed just under 10,500 units in the past decade and it aims to develop between 900 and 1,200 units a year for 2015-2020. The tenure split is expected to be 20% affordable rent, 20% shared ownership, 20% private rent and 40% private sale, although this is under review.

RATING SENSITIVITIES
The standalone ratings may be downgraded if there is further pressure on the sector or on A2D as a result of the negative operating environment in the UK.

The ratings may also be downgraded in the event of:
- Increased volatility in operating revenue as a result of higher exposure to development activities and a significant increase in gearing and net debt/EBITDA ratios.
- Greater pressure on headroom on existing interest cover and gearing covenants.
- Further reliance on sales receipts than those expected.
- Further changes passed by government negatively affecting the revenues of RPs.

Conversely, the IDRs could be upgraded if the net debt to Fitch-calculated EBIDTA declines below 8x on a sustained basis.

The Outlook on the UK sovereign is Negative and in the event of further downgrade Fitch may re-assess the impact that the sovereign credit metrics weakening would have on the RPs' standalone credit profiles, notching uplift and ratings relativity.

FULL LIST OF RATING ACTIONS
Long-Term Foreign- and Local-Currency IDRs affirmed at 'A+'; Outlooks Stable
Short-Term IDR affirmed at 'F1'
GBP1 billion EMTN programme long-term rating affirmed at 'A+'
GBP250 million senior unsecured long-term rating affirmed at 'A+'
A2D Funding plc and A2D Funding II plc's long-term local-currency unsecured bonds affirmed at 'A+'

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Applicable Criteria
Government-Related Entities Rating Criteria (pub. 07 Feb 2018)
https://www.fitchratings.com/site/re/10019302
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113